



Comptroller of the Currency
Administrator of National Banks

A Pocket Guide to

Red Flags in Board Reports



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OFFICE OF THE COMPTROLLER OF THE CURRENCY

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This pocket guide is a short version of *Red Flags in Board Reports—A Guide for Directors*, September 2000. For a complete list of red flags and a fuller discussion of each topic, please consult the book.

Capital Red Flags:

- Ratios below “adequately capitalized.”
- Declining capital levels or ratios.
- Concentration in nontraditional activities.
- Capital growth rate is less than total asset growth rate.

Asset Quality and Credit Risk Red Flags:

- Significant increase in loans to total assets ratio.
- Significant increase in loan to equity ratio.
- Significant change in portfolio mix.
- Significant upward or downward trend in the percent of the ALLL to total loans and leases.
- High growth rates in total loans or within individual categories of loans.
- Significant increase in loan yields.

- Loan yields significantly higher than peer group.
- Downward trends in risk ratings among pass credits, and or increases in special mention or classified assets.
- Increasing levels of past-due and nonperforming loans, loan losses, interest earned not collected, OREO, or other repossessed assets as a percent of loans or assets.

Earnings Red Flags:

- Significant increases or decreases in noninterest income.
- Significant variances from budgeted amounts on income/expense items and balance sheet accounts.

Liquidity Red Flags:

- Significant increases in reliance on wholesale funding.
- Significant increases in large certificates of deposit, brokered deposits, or deposits with interest rates higher than the market.
- Mismatched funding—funding long-term assets with short-term liabilities or short-term assets with long-term liabilities.
- Significant increases in borrowings.

Interest Rate Risk Red Flags:

- The inability of management to provide reports that identify and quantify the major sources of the bank's interest rate risk in a timely manner and describe assumptions used to determine interest rate risk.
- Noncompliance with the board's established risk tolerance levels and limits.
- Unauthorized exceptions to interest rate risk policy.
- Capital falling below the level established by the board to support interest rate risk.
- Changes in the level and trends of aggregate interest rate risk exposure.

Growth Red Flags:

- Growth that is not consistent with the bank's budget or strategic plan.
- Growth that is not accompanied by an increasing level and sophistication in risk management controls.
- Introduction of new products or activities with little or no expertise or inadequate risk management controls.

Loan Portfolio Red Flags:

- Large or increasing volume of loans granted or renewed with policy exceptions.
- Large or increasing volume of credit/collateral exceptions.
- Loans remaining on the problem loan list for extended periods of time without improvement.
- Loan review personnel reporting to a person(s) other than the board or a board committee.
- Delinquent internal loan reviews or late identification of problem loans.
- Large concentrations of credit to individuals or industries with or without prior board approval.
- Loans to directors, significant shareholders, management, and other insiders (including third parties performing services for the bank, external accountants, auditors, and marketing firms).
- Loans to affiliates.

Investment Portfolio Red Flags:

- Purchase of individual securities that do not meet board guidelines on risk, quality, or quantity.
- Securities purchased without pre-purchase analysis.
- Securities purchased from only one securities dealer.
- Large numbers of below-investment-grade (lower than BBB or Baa) or unrated bonds.
- Significant changes in the type, quality, or maturity distribution of the portfolio.
- Sale of securities previously designated held-to-maturity, or transfer of securities from the held-to-maturity account to the available-for-sale account.
- High volume of purchases and sales.

Financial Derivatives and Off-Balance-Sheet Activities Red Flags:

- Participation in transactions without appropriate knowledge of derivatives or experience in the market.
- Substantial exposure to a counterparty whose ongoing ability to meet its obligations is uncertain.

- Advancing funds to borrowers in financial difficulty, noncompliance with covenants, or other circumstances that make lending to them imprudent.
- Inadequate funding sources for anticipated usage of loan commitments and lines of credit.

Audits and Internal Control Red Flags:

- Any indications that management is trying to control or inhibit communications from internal audit staff to the board of directors.
- A qualified, adverse, or disclaimer opinion from an external auditor.
- Unreconciled differences between trial balances, subsidiary ledgers, and the general ledger.
- Significant internal control or other deficiencies noted in audit reports that have not been corrected.
- Audit reports that do not address identified internal control weaknesses.
- An external auditor or audit firm that has a financial interest in the bank, loan from the bank, or other conflict of interest.

Consumer Compliance Red Flags:

- Significant deficiencies identified in compliance reviews that have not been corrected in a timely manner.
- Significant turnover or a reduction in the staff responsible for ensuring compliance with law or specific consumer products.
- Lack of evidence that compliance was adequately considered when new products and delivery systems were introduced.
- A significant increase in customer dissatisfaction and complaints (either received directly or sent to the OCC).

Fair Lending Red Flags:

- An existing or proposed lending policy that includes, directly or indirectly, reference to any prohibited basis (race, color, national origin, religion, sex, age, marital status, familial status, handicap, receipt of public assistance, or the exercise of a right under the Consumer Credit Protection Act).
- Any statements by officers, employees, or agents indicating a preference, prejudice, or stereotyping on a prohibited basis, or an aversion to doing business in minority areas.

- Segmentation of product markets, advertisements, promotions, application channels, or other access to credit along the lines of racial or national origin characteristics of applicants or geographic areas.
- Consumer complaints alleging discrimination in specific transactions.

CRA Red Flags:

- Substantial disparities in the numbers of loans originated within groups of contiguous low- or moderate-income geographies.
- Reports that show lending performance significantly below the performance of other lenders in the bank's assessment area, particularly its primary competitors.
- Reports that show that the bank has few or no qualified investments in its assessment area even though investment opportunities exist.
- Customer complaints about the level of services and products offered in some parts of the bank's trade area compared with those offered in other areas served by the bank.

BSA Red Flags:

- Audit does not test for suspicious activity.
- Bank personnel are not regularly trained on the BSA and how to identify possible suspicious activity.
- The volume of SARs or CTRs is very high or very low.
- Customers have an unusually large volume of cash or use a disproportionate amount of cash versus checks.
- Customers use an unusually large volume of wires, official checks, money orders, or traveler's checks especially to or from a high-risk geographic area.
- The bank acquires large deposit relationships but management is unfamiliar with the depositor's business or line of work.

Asset Management Red Flags:

- Unanticipated or unexplained changes in business strategies.
- Substantial changes or growth in account types, account balances, or products and services offered.

- The existence of accounts with unusually high cash balances or large extended overdrafts.
- Accounts that are closed shortly after being opened and funded.
- High volumes of exchanged annuities, switched mutual funds, or early redemptions of retail brokerage investments.
- Purchases of fiduciary securities or sales of securities through a retail brokerage unit that were securities not previously approved by the board or investment committee.
- Fiduciary assets of a kind the bank lacks expertise to manage (e.g., mineral interests or farm/ranch properties).

Management Information System Red Flags:

- A lack of system audits or unresolved audit deficiencies.
- Management is unable to provide a basic diagram of the system architecture or a comprehensive list of service providers.
- MIS reports that are untimely, incomplete, or inaccurate.

Internet Banking Red Flags:

- Unresolved or repeat audit deficiencies.
- A system that does not have regular review and certifications by independent auditors, consultants, or technology experts.
- Management that is unable to provide a basic description of the system architecture, a comprehensive inventory of service providers, or effective vendor management.
- Systems, products, or services that are inconsistent with the bank's strategic plan.

Overall Assessment Red Flags:

- A composite, component, or specialty rating that is lower than in previous examinations. Directors are particularly concerned about ratings of 3, 4, and 5.
- High or increasing level of classified assets.
- "Matters Requiring Attention" or items of concern in the "Overall Conclusions" section of the report of examination.
- Many or repetitive violations of law.

- A risk category in which the rating is inconsistent with the risk tolerance of the bank.
- A risk category in which the quantity of risk is moderate or high and the quality of risk management is rated as weak.
- Reference to noncompliance with bank policy or recurring internal control deficiencies.
- Reference to an activity for which directors may be liable or subject to civil money penalties.

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